[Academic Script]

Dividend decision in financial management

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1. Introduction

In this session we are going to discuss dividend decision in financial management.

Let us first understand the Concept of dividend:

The word 'dividend' is derived from the Latin word "Dividendum" which means "that which is to be divided". This distribution is made out of the profits remained after deducting all expenses, providing for taxation, and transferring reasonable amount to reserve from the total income of the company.

Dividend refers to that part of profits of a companies which is distributed by the companies among its shareholders.

According to accounting: "dividend is nothing but the distance of profit (accounting)"

In economics dividend is "Cost of finance" or Cost of Capital

Now let us see various Types of dividend:

Cash dividend: The cash reward is given to the stakeholders of the companies in the form of dividend. In India only cash dividend is there according to the guidelines issued by SEBI.

Bonus dividend OR Stock Dividend: Stock dividend is next to cash dividend in respect of its popularity. Payment stock dividend is popularly termed as "issue of bonus shares" in India. But in India issue of Bonus shares are not permitted by SEBI.

Property Dividend: In case of such dividend the company pays dividend in the form of assets other than cash. This may be in form of company's products. This type of dividend is not popular in India.

Optional dividend: Companies give options to stakeholders to accept cash dividend or bonus dividend.

Scrip dividend: It is given in the form of promissory notes. On specified period amount is payable. It is also known as "dividend certificate."

Here it should be noted that As per Indian Companies Act 2013 companies can pay dividend in the form of cash only

2. Dividend policy

The next topic we are going to discuss is Dividend policy

The term dividend policy refers to the policy concerning quantum of profits to be distributed as dividend. The concept of dividend policy implies that companies through their Board of Directors evolve a pattern of dividend payments, which has a bearing on future action.

As per Weston and Brigham, "Dividend policy determines the division of earnings between payments to shareholders and retained earning".

Do you know the Factors affecting dividend policy or which are the determinants of dividend policy?

The factors are:

- Type of business
- Earning of current year
- Dividend of previous year
- Expected profit of future year
- Requirement of additional capital
- The proportion of reserve in the companies
- Liquidity status

- Legal restrictions
- Attitude of management

Now let us understand various Types of dividend policy. The dividend policies are Regular, Stable, Irregular and No dividend policy.

(a) **Regular dividend policy**: Payment of dividend is done at usual rate. Mostly retired employees, widows other economically maker person prefer these dividend.

(b) **Stable dividend policy**: It means consistency or lack of variability's in dividend payout. Further they are classify into three forms:

- Constant dividend per share
- Constant payout ratio
- Companies policy

(c) **Irregular dividend policy**: Some companies follow this kind of policy where there is uncertainty of earnings, lack of liquidity and many more.

(d) **No dividend policy**: A company may follow this kind of policy because of its unfavorable working capital position or on account of requirement of funds for future expansion and growth.

Now let us see the Relationship between dividend and share price:

The relationship between them is unsolved question. Since, many years, many theories have written and list out there opinion. According to M.M HYPOTHESIS dividend is irrelevant with the value of the share price. While, WALTER AND GORDAN MODEL describe that dividend is relevant with the value of share price.

3. Theories of dividend

Our next topic is Theories of dividend:

Dividend decisions are been categorized into two forms:

Payment of dividend.

Non-payment of dividend.

According to these models are also classify as dividend relevance or irrelevance:

Dividend relevance models:

1. Traditional theory
2. Walter’s Model of Dividend Relevance
3. Gordon’s Model of Dividend Relevance
4. John Williams on Dividend Relevance

Dividend irrelevance model:

Modigliani and Miller Hypothesis of Dividend Irrelevance

Let us first understand the dividend relevance model

WALTER’S MODEL OF DIVIDEND RELEVANCE

James E. Walter has presented a model in 1963, which explains the relevance of dividend for valuation of shares or maximization of wealth. This was published having title “Dividend Policy”. The message of this theory is divided into 3 different situations.

Where,

r= rate of return

k= cost of capital

Situation-1

When r is greater than k, market value of equity share would increase.

Situations-2

When r is equal to k, market value of equity share would remain constant.

Situations-3

When r is less to k, market value of equity share would decreases.

Assumptions of this model are:

1. The firm finances all investment through retained earnings; that is debt or new equity is not issued.
2. The firm's rate of return (r) and cost of capital (k) are constant.
3. All earnings are either distributed as dividend or retained internally immediately.
4. There is no change in the earnings per share (EPS) and dividend per share (DPS). They may be changed in the models to determine the results.
5. The firm has a very long or infinite life.

Share Valuation Formula: (10)

Walter put forward the share valuation formula as:

$P = D/k + [r\,(E-D)/k]\,/k$

The above equation can also be written as:

$P = [D + (E - D)\, r / k] / k.$

Where, P = Price per share

D = Dividend per share

E = Earnings per share

(E-D) = Retained earnings per share

r = Rate of return on investments

k = Cost of capital

The above formula suggests that the market value of share is the sum of

(i) The present value of all dividends (D/k) and

(ii) The present value of all capital gains, which occur when earnings are retained in the firm. [r (E-D) / k] / k.

Limitations of this model are:

1. It assumes that the firm's investments are financed exclusively by retained earnings and no external financing is used. It is an unrealistic assumption.
2. It assumes that 'r' is constant. This is not a realistic assumption because when increased investments are made by the firm, r also changes. Thus, this model becomes incorporative.
3. It assumes that 'k' is constant. By assuming k to be constant, it ignores the effect of risk on the value of firm.

Explanation:

According to this model the dividend decision are relevant and totally depend upon the rate of earning per share.

4. Gordan's model

It Gordon's Model is based on relevance of dividend concept. This model was published in the book title:" The investment, financing and valuation of corporation". It is also known as "dividend capitalization model" (1962).

According to Myron J. Gordon dividends are relevant and dividend policy affects the value of firm. It is based on the relationship of dividend policy and market value of shares.

Assumptions of this model are:

1) The firm capital consists of only equity shares. There is no debt capital.

2) The firm uses only retained earnings for financing its investment programmes. No external financing is used.

3) The internal rate of return of the firm (r) is constant.

4) The cost of capital or the appropriate discount rate (k) of the firm is constant.

5) The firm has perpetual life and its earnings are also perpetual.

6) There are no corporate taxes.

7) The retention ratio (b), once decided upon is constant. (Retention ratio is the proportion of earnings retained in the business.) Thus, the growth rate g = br is constant.

8) k > br. If this condition is not fulfilled we cannot get a meaningful value for the shares.

- Gordan has explain his model again for situation when:
- R=k
- R>k
- R<k

Formula:

Determine the market value of the firm:

P_O = E (1-b)/k-g

Where,

$P_{O\,=}$ Market price of share

E= earnings per share

B= retention ratio

K= cost of capital (exp. Rate of return of equity share holder)

G= growth rate in r

Explanation: This model is relevant for dividend decision and depends upon the market value of the equity.

5. Dividend irrelevance model

Now let us understand dividend irrelevance model:

M.M. MODEL(1961)

Franco Modigliani and Merton H. Miller advocate that, the dividend policy of a firm is irrelevant, as it does not affect the wealth of the shareholders. Thus, dividends are irrelevant.

It depends on the firm's earnings, which result from its investment policy. When investment decision of a firm is given, the dividend decision is of no significance in determining the value of firm.

Assumptions:

1. There exist perfect capital market and investors are rational.
2. Information is available to all free of cost.
3. There is no investor large enough to influence the market price of securities.
4. There is no transactional cost.
5. There is no floatation cost of raising new capital.
6. There exists no taxes or there is no difference in tax rates applicable to dividends and capital gains.
7. The investment policy of the firm is fixed and does not change. So the financing of investment programmes through retained earnings does not change the business risk and there is no change in required rate of return.

Explanation:

It explain that the dividend decision is not worth because when firm capitalization value is increase the share price will increase automatically. So, dividend decision for the firm is irrelevant

As arbitrage process is much there in the market so declaration of good dividend cannot stop it so it is not worth it.

Limitations of this model are:

1. MM assumes that capital markets are perfect. This implies that there are no taxes, floatation costs do not exist and there is absence of transaction costs. These assumptions are not valid in actual conditions.
2. Apart from the market imperfection, the validity of the MM hypothesis, insofar as it argues that dividends are irrelevant, is questionable under conditions of uncertainty.
3. Moreover, majority of shareholders being small investors they prefer current income to meet their consumption requirements.
4. Lastly, the payment of dividend conveys to the shareholders.

Conclusion:

Modigliani and Miller ignores this facts but powerfully expressed by Gordon. Investors prefer dividend to capital gains. So shares with higher current dividends, other things being equal, command higher price in the market.

6. Summary

In this session we discusses the concept of Dividend, Dividend Policy, Types of Dividend, factors affecting Dividend, Types of Dividend Policies, Relationship between Dividend and Share prices and various dividend relevance and irrelevance models.